reductions are plainly incapable bringing all of its UNE rates within the range that a reasonable application of TELRIC principles would have produced.

67. Moreover, there is no non-arbitrary basis upon which the Commission could conclude that even the rates that were discounted are now within the range of rates that a reasonable application of TELRIC principles would have produced. SWBT has provided no cost basis for the arbitrary percentage discounts it applied. And SWBT has refused to provide the Commission and interested parties electronic access to the cost models used to generate its approved rates to which the discounts apply. There is accordingly no way for the Commission to verify that SWBT's arbitrary rate reductions are sufficient to offset the inflation caused by its many TELRIC violations. Instead, SWBT has adopted a "trust me" approach, whereby it simply asserts that its rate reductions are sufficient to "allay any lingering concerns" about its inflated rates. Hughes MO Aff. ¶ 56. And the few electronic files that SWBT did disclose in its original section 271 Application proceeding create more questions than answers. Those data and spreadsheets are incomplete and are, in some cases, inconsistent.

68. *First*, the spreadsheets and document files provided by SWBT include no underlying data to show how switching and other non-loop related costs were developed. Consequently, like other parties in this proceeding, I was unable to replicate any of SWBT's non-loop cost studies or to determine the extent to which errors in those cost studies inflate SWBT's recurring UNE rates. For instance, SWBT's switching cost studies include investment additives for additional switch hardware that the Missouri Public Service Commission Staff

[22] These discounted rates are detailed in the MPSC's Order Granting Motion To Accept Revised Missouri Interconnection Rates, *Application of SWBT et al. to Provide Notice of Intent to File an Application For Section 271 Authorization*, Case No. TO-99-227 (August 30, 2001).

criticized on the grounds that those additives are already included in SWBT's Switch Cost Information System/Model Office or elsewhere in SWBT's cost studies. The impact of those plain errors cannot be fully assessed without full access to SWBT's switching cost studies.

69. *Second*, the files that were provided by SWBT are incomplete because they include only summaries and descriptions of its cost studies, and do not contain the underlying detail of data that SWBT used in its cost models. In fact, the spreadsheets and document files provided by SWBT do not include even the sample survey of inputs that SWBT actually used in its LPVST model to compute loop costs. Instead, SWBT provided an entirely different data set, entitled "MO 1997 Inputs.xls," which contains only summaries and averages of the outside plant used by SWBT to compute loop costs. These data are not sufficient to meaningfully replicate SWBT's cost studies or to measure the extent to which errors in SWBT's cost studies inflate UNE-loop rates. For example, as I explained in my initial declaration, SWBT's actual sample survey replicates the inefficiencies of the embedded network by incorrectly assuming that the feeder and distribution cable sizes in place today are reflective of the forward-looking efficient cable sizes. The summaries and averages provided by SWBT do not provide sufficient information to reproduce SWBT's cost studies using the correct forward-looking cable sizes to determine the full impact of this error.

70. *Third*, the data sets provided by SWBT contain conflicting data, making it impossible to replicate or rely on SWBT's cost studies. For instance, there are unexplained discrepancies between SWBT's "CAPCS MO CASE TO-97-40" and "Missouri 96ACF" spreadsheets. SWBT claims that both spreadsheets use the Missouri Staff's inputs, yet the two spreadsheets produce conflicting outputs. For example, the annual depreciation factor for aerial cable computed by the CAPCS MO CASE TO-97-40 spreadsheet is almost 3 percentage points

higher than that computed by the Missouri 96ACF spreadsheet. Similar discrepancies exist for each of the individual asset accounts included in the SWBT cost study. And there is no explanation for these discrepancies contained in the documentation provided by SWBT (the "CAPCS DOCUMENTATION.DOC" file). In short, SWBT's failure to provide third parties and the Commission with electronic versions of its cost studies renders it impossible for the Commission to make any non arbitrary finding that those rate reductions are sufficient to offset the rate inflation caused by the TELRIC violations in its cost studies.

D. Missouri's UNE Costs Have Declined Significantly During The Past Several Years.

71. SWBT's cost studies rely on pre-1997 vintage data. Therefore, even if (contrary to fact) SWBT's flawed cost studies combined with its recent targeted rate reductions could produce TELRIC-compliant rates for 1997, those rates would still be far above TELRIC levels *today*.

72. The reason is simple: as recognized by this Commission, the costs of providing UNEs have fallen significantly in past few years.[23] A straightforward analysis of SWBT's Missouri switch investments and its dial equipment minutes ("DEMs"), for example, reveals that forward-looking switch costs have plummeted. *See* Lieberman AR/MO Decl. ¶ 27 & Exhibits

[23] *See, e.g.*, Order on Remand and Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Intercarrier Compensation for ISP-Bound Traffic*, CC Dockets No. 96-98 and 99-68, FCC 01-131, at 84, n. 157, 93 (April 27, 2001) (citing Letter from David J. Hostetter, SBC, to Magalie Roman Salas, Secretary, FCC (Feb. 14, 2001), Attachment (citing September 2000 Morgan Stanley Dean Witter report that discusses utilization of lower cost switch technology); Donny Jackson, "One Giant Leap for Telecom Kind?," Telephony, Feb. 12, 2001, at 38 (discussing cost savings associated with replacing circuit switches with packet switches); Letter from Gary L. Phillips, SBC, to Magalie Roman Salas, Secretary, FCC (Feb. 16, 2001) (attaching press release from Focal Communications announcing planned deployment of next-generation switching technology "at a fraction of the cost of traditional equipment").

12-13. As noted above, SWBT's Missouri cost studies are based on pre-1997 switching investment costs. Between 1996 and 2000 (the most recent years for which this information is available), net switch investment has remained virtually stagnant while the DEMs for SWBT have grown significantly. *See id.* The nearly stagnant investment, combined with the explosive increase in minutes, results in a nearly 23 percent decline in switching investment per DEM between 1994 and 1999. *See id.*

73. Put simply, even if SWBT had established that its rate reductions offset the rate inflation caused by the TELRIC violations in its cost studies, SWBT's UNE rates would only be TELRIC-compatible for the base year data on which those cost studies are based. And because costs have declined dramatically in the past few years, SWBT's Missouri rates would not be cost-based today.

III. ARKANSAS

74. On July 24, 2000, SWBT filed a draft of its federal section 271 Application with the APSC requesting that the APSC issue an order or report indicating its support of SWBT's section 271 application, and to file that report with this Commission.[24] The APSC refused to issue such an order finding, among other things, that SWBT's proposed rates appear to be above those that could comply with Checklist Item 2. *See Consultation Report* at 12-13. On March 23, 2001, SWBT filed its response to the commission's Consultation Report, wherein, SWBT

[24] *See* Consultation Report of the Arkansas Public Service Commission to the Federal Communications Commission Pursuant to 47 U.S.C. Section 271(D)(2)(B), *Application of SWBT et al. for the Approval of the Arkansas Interconnection Agreement*, Docket No. 00-211-U, at 1-2 (December 21, 2000) ("*Consultation Report*").

"mirrored Kansas UNE prices."[25] The APSC recommended those rates to this Commission for section 271 approval based on the fact that SWBT's Kansas and Arkansas recurring and nonrecurring costs are similar. *See Second Consultation Report* at 8. The APSC made no independent investigation of those rates or SWBT's underlying cost studies. The APSC overlooked the fact that SWBT's Kansas NRCs are not TELRIC compliant, and far exceed the NRCs of all other section 271 approved states, including Texas.

75. In its 1999 *Final Order* the Kansas Corporation Commission ("KCC") "agree[d] with AT&T" that NRCs should be based "on the assumption that all orders are processed electronically" with "a low fall-out rate" and that "an assumption of 100% DIP [or dedicated Inside Plant] is appropriate." *KCC Final Order* at 31-32.[26] Apparently believing that SWBT's cost studies largely conformed with these critical forward-looking assumptions, the KCC established very high NRCs "within the range proposed by the parties. *See id.* at 32 & Attachment B.

76. On reconsideration, the KCC recognized that this was not the case and that "SWBT's proposed NRCs are in most cases overstated." *KCC Recon. Order* at 26. The KCC ordered SWBT to "rerun NRC studies" and to "use a fall out rate of 5%," to "assume electronic

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[25] *See* Second Consultation Report of the Arkansas Public Service Commission to the Federal Communications Commission Pursuant to 47 U.S.C. Section 271(D)(2)(B), *Application of SWBT et al. for the Approval of the Arkansas Interconnection Agreement*, Docket No. 00-211-U, at 8 (December 21, 2000) ("*Second Consultation Report*").

[26] "DIP and DOP refer to the situation where facilities are dedicated to customers and the telephone plant is permanently wired into the network at the central office switch (DIP) and in the cabling from the central office to the customer premises (DOP). . . . SWBT already uses DIP (*i.e.*, SWBT leaves the loop and port connected) for its own internal operations. This procedure minimizes the inefficiencies when one SWBT customer replaces the original one. . . . It would be illogical and inconsistent to use a different assumption for calculating NRCs associated with those same UNE elements." *KCC Recon. Order* at 29.

processing," and to "assume a 100% Dedicated Inside Plant ("DIP") and an 80% Dedicated Outside Plant ("DOP") factor." *KCC Recon. Order* at 27. *See also id.* (noting that "both SWBT and AT&T seem to acknowledge" that a "1-2% fall out rate" is achievable in the long run); *id.* at 28 ("Staff and AT&T have persuasively argued that charges for NRCs should not be based on inefficient manual processing systems"); *id.* at 26-28 ("electronic processing is a reasonable assumption for calculation of nonrecurring costs, which is consistent and arguably required under the TELRIC costing principles which this Commission and the FCC have adopted").

77. But SWBT ignored these directives. *See KCC NRC Order* at 13 ("Staff notes that in spite of direct language in Commission orders, SWBT submitted a cost study based on fully manual processes; *id.* at 27 ("The Commission specifically directed SWBT to use a fall out rate of 5 percent"); *id.* at 14 ("Beyond the electronic service order cost study, SWBT continues to make a variety assumptions regarding fallout"); *id* at 15 ("The Commission required the use of a 100 percent DIP factor in calculating non-recurring costs. According to staff, it could find no evidence that SWBT complied with this provision of the Order on Reconsideration."); *id.* at 35 ("SWBT should have complied with the Commission's orders in this case"). In fact, given the KCC's Reconsideration Order finding that the resubmission of cost studies was necessary because SWBT's original proposals were "overstated," the prices "in SWBT's re-submitted cost study [were] significantly *higher* than the prices submitted in SWBT's original cost studies." *Id.* at 41 (emphasis added).

78. SWBT's Kansas non-recurring cost studies were also rife with other irregularities. *See, e.g. id.* at 25 ("SWBT cannot provide any objective verification for its labor cost assumptions except for the hourly rate charged" and "for those functions requiring labor, it appears that SWBT has overstated costs associated with labor"); *id.* at 22 ("The Commission

notes that SWBT's cost studies filed electronically in many instances do not match the paper copy filed with the Commission. Many of the Studies utilize calculations not contained within the electronic files provided").

79. Rather than remedy SWBT's refusal to comply with clear and direct KCC orders by accepting AT&T's TELRIC-based proposals or ordering SWBT to rerun its studies yet again, however, the KCC used the concededly unlawful SWBT proposals to set permanent NRCs. In some cases, the KCC accepted SWBT's proposals as is. *See KCC NRC Order*, Attachment B at 10 n. 8. In other cases, the KCC left the NRCs unchanged from the 1999 Final Order, notwithstanding the Reconsideration Order finding that those rates were generally "overstated." *See id.* at 10 n. 1. And for the majority of important NRCs, the KCC employed an entirely arbitrary "split the baby" approach setting the NRC at the weighted average of the AT&T and SWBT proposals (2/3 AT&T and 1/3 SWBT). *See id.* at 10 n.2. The KCC did not even attempt to support these determinations as cost-based.

80. The one-third/two-third approach still resulted in inflated rates. Because SWBT's rate proposals were based on non-TELRIC assumptions, its rates were already significantly inflated. Thus, even weighting SWBT's proposals at "only" one-third had the effect of producing NRCs that were, two times or more higher than the comparable Texas rates. *See also KS/OK DOJ Eval.* at 26-27.

81. SWBT itself apparently recognized that its NRCs were clearly excessive and volunteered an insufficient "25 percent discount" to those rates, which are SWBT's current

Kansas rates that were imported into Arkansas.[27] But that 25 percent discount to rates that are already as much as 100 percent, above cost-based levels was clearly insufficient to bring SWBT's Kansas NRCs – and now Arkansas NRCs – within the realm of TELRIC compliance.

82. The excessive nature of SWBT's Kansas NRCs – which SWBT has imported into Arkansas – is obvious when those NRCs are compared to SWBT's Texas NRCs. For instance, SWBT's UNE-P NRC for Analog to Switch Port Cross-Connect is **[BEGIN PROPRIETARY] [END PROPRIETARY]** compared to only **[BEGIN PROPRIETARY] [END PROPRIETARY]** in Texas. *See* Flappan/Browne KS Decl. ¶¶ 7-9 (attached as Exhibit 3). Likewise, SWBT's Kansas individual UNE NRCs DS1 Trunk Port, Dedicated Cross Connect Voice Grade 2w, STP Port, White Page Information Zone 3, and Feature Activation Charges are from two-thirds to fifty times than those in Texas. *See id.*

83. These intrastate NRC disparities are significant and telling. As correctly pointed out by the KCC, "NRCs should not be expected to vary significantly across SWBT's jurisdictions because the activities associated with the NRCs are expected to be very similar across these jurisdictions." *KCC Recon. Order* at 26. *See also KCC Final Order* at 32 ("variances between Kansas [NRC] prices and other states should be limited"). Thus, the fact that SWBT's Kansas NRCs (and now Arkansas NRCs) significantly exceed those of Texas strongly suggests that SWBT's Kansas and Arkansas NRCs are well outside the bounds of TELRIC compatibility.

[27] *See Ex Parte* Presentation, Letter to Magalie Roman Salas, Secretary, from Goeffrey M. Klineberg (filed December 28, 2000) ("Dec. 28 *ex parte*").

84. SWBT has argued that the massive differences in NRCs in Kansas and Texas can be explained by differences in opinion among the Kansas and Texas commission's. For example, SWBT claims that the rate disparities between Kansas and Texas reflect a difference in opinion between the two commissions as to whether to allow a "trip charge." That is clearly wrong. First, there was no trip charge proposed in Kansas or approved by the KCC. But even if such a trip charge were approved by the KCC that would be unlawful. Indeed, the Texas Public Utility Commission ("TPUC") squarely rejected the inclusion of such charges in SWBT's Texas NRCs. That finding was proper because, as AT&T's testimonials established, SWBT's proposed Texas "trip charges" reflected phantom "trips" that would never occur.[28]

85. SWBT's inflated Arkansas NRCs will have an especially adverse impact on CLECs ability to successfully compete for new customers. As this Commission has recognized, "[a] substantial percentage of the customers that purchase CLEC local services are [classified as] 'new service' customers" (Kansas/*Oklahoma 271 Order* ¶ 61 n.168) for which SBC NRC rates are 48 percent higher. *See* Flappan/Browne KS Decl. ¶ 8. As a result, SWBT's inflated NRCs ensure that its competitors incur average costs that are much higher than SWBT's own costs. That is presumably precisely what Checklist Item 2 is designed to prevent.

IV. CONCLUSION

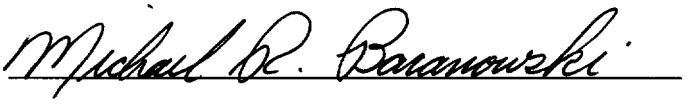
86. SWBT's cost studies, as adopted by the MPSC, overstate SWBT's UNE costs by violating numerous fundamental TELRIC principles, including the use of a non-TELRIC "reproduction" rather than a "replacement" cost model, and significantly inflated depreciation

[28] See Ex Parte Letter from Dina Mack, AT&T, to Magalie Roman Salas, FCC Secretary, Joint Application o f SBC et. al. for Provision of In-Region InterLATA Service in Kansas and Oklahoma, CC Docket No. 00-271 (filed January 17, 2001).

and common cost factors. In addition, SWBT's cost models rely on myriad flawed loop- and switch-specific assumptions that further inflate those costs. SWBT has impeded any analyses to determine the exact impact of these TELRIC violations by refusing to make electronic version so of its cost studies available for review, and those electronic files that SWBT has disclosed appear to be flawed. Finally, the handful of arbitrary rate discounts offered by SWBT are not sufficient to overcome the significant amount of rate inflation caused by those TELRIC errors.

VERIFICATION PAGE

I, Michael R. Baranowski, declare under penalty of perjury that the foregoing is true and correct.



Michael R. Baranowski

Executed on September 12, 2001.

EXHIBIT 1

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the matter of		
Application by SBC Communications Inc.,	)	
Southwestern Bell Telephone Company, And	)	
Southwestern Bell Communications Services, Inc.	)	**CC Docket No. 01-88**
d/b/a/ Southwestern Bell Long Distance For Provision	)	
of In-Region, InterLATA Services In Missouri	)	

DECLARATION OF

RICHARD N. CLARKE

ON BEHALF OF

AT&T CORP.

Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of	)	
	)	
Application by SBC Communications Inc.,	)	
Southwestern Bell Telephone Company, And	)	CC Docket No. 01-88
Southwestern Bell Communications Services, Inc.	)	
d/b/a/ Southwestern Bell Long Distance For	)	
Provision of In-Region, InterLATA Services	)	
In Missouri	)	

DECLARATION OF RICHARD N. CLARKE
ON BEHALF OF AT&T CORP.

Based on my personal knowledge and on information learned in the course of my duties, I, Richard N. Clarke, declare as follows:

1. My name is Richard N. Clarke. My business address is 295 North Maple Avenue, Basking Ridge, NJ 07920.

2. I am employed by AT&T Corp. ("AT&T") as a Division manager in AT&T's Law and Government Affairs organization. In this position I am responsible for AT&T's economic policies related to the costing and pricing of local telecommunications services. I have directed AT&T's investigations into the structure of efficient pricing methods for telecommunications elements and services and AT&T's participation in the development of the HAI/Hatfield Model of forward-looking economic costs of local exchange networks and services. I also have experience in evaluating other local exchange costing models and methodologies such as the BCPM and the Federal Communications Commission's ("Commission's") Synthesis Model.

3. I have a Bachelor's degree in mathematics and economics from the University of Michigan and a Master's degree and a Ph.D. in economics from Harvard. Prior to joining AT&T with Bell Laboratories in 1986, I was an Assistant Professor of Economics at the University of Wisconsin-Madison, and worked as an Economist in the Antitrust Division of the U.S. Department of Justice.

4. Over the past dozen years, I have provided testimony before numerous regulatory commissions, including those of Texas, Wisconsin and this Commission, among others. Much of this testimony has dealt with economic, costing and pricing issues related to local exchange competition.

I. INTRODUCTION AND SUMMARY

5. The purpose of my declaration is to demonstrate that the pricing of interconnection and unbundled network elements ("UNEs") is of critical importance in making possible widespread competitive entry into local exchange markets. Furthermore, even modest overstatements in the pricing of interconnection and UNEs are likely to have profound import for whether competitive entry will occur at all – or whether even existing competitive entries by competitive local exchange carriers ("CLECs") will be sustained.

6. Although the critical importance of pricing has always been well-known to economists and businesspeople, this declaration demonstrates empirically the financial significance that even modest overstatements of input prices would have for typical firms in the U.S. economy. In particular, even a 10% reduction in a firm's net revenues (as would occur if the price of a firm's purchased inputs that comprise two-thirds of its revenues were inflated by 15%) would virtually *eliminate* the profits (returns on equity or returns on debt plus equity) earned by the average firm in the Standard & Poor's 500 Index. Indeed, the average firm in the

S&P 500 would also see its EBIT or EBITDA margins cut roughly in half by such an occurrence.[1]

7. Thus, it is essential that rates for interconnection and UNEs be set accurately at their Total Element Long-Run Incremental Cost ("TELRIC") because, as the Commission has previously recognized, UNE prices based on forward-looking, economic costs are critical for the development of UNE-based competition in the local exchange market.[2] Any assumption that full and accurate compliance with the TELRIC standard is of secondary importance, and that wide competitive entry can be expected to occur as long as UNE prices are within a "range" of TELRIC compliance, is completely unfounded. Even slight overstatements of UNE rates above TELRIC levels severely impede competition across local exchange markets.

8. Because the costs associated with purchased UNEs typically represent at least 70 percent of the total revenues (including access, vertical features and other incidental revenues) that a CLEC can expect to receive as a UNE-based provider of local exchange and

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[1] EBIT measures Earnings Before Interest and Taxes; EBITDA measures Earnings Before Interest, Taxes, Depreciation and Amortization.

[2] *See, e.g., Implementation of the Local Competition Provisions of the Telecommunications Act of 1966,* First Report and Order, 11 FCC Rcd. 15499, ¶ 679 (1996), *aff'd in part and vacated in part sub nom. Iowa Utils. Bd. v. FCC,* 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) (stating that adopting a pricing methodology based on forward-looking, economic costs "simulates the conditions in a competitive marketplace" and "allows the requesting carrier to produce efficiently and compete effectively, which should drive retail prices to their competitive levels"); *Application of Ameritech Michigan Pursuant to Section 271 to Provide In-Region, InterLATA Services in Michigan,* 12 FCC Rcd. 20543, ¶ 287 (1997) ("Determining cost-based rates has profound implications for the advent of competition in the local markets and for competition in the long-distance market. Because the purpose of the checklist is to provide a gauge for whether the local markets are open to competition, we cannot conclude that the checklist has been met if the prices for interconnection and unbundled elements do not permit efficient entry").

exchange access services,[3] each one percent overstatement in UNE prices reduces a CLEC's "top-line" net revenues by more than 0.7 percent. Thus, a 15 percent overstatement in UNE prices reduces the net revenues available to CLECs by at least 10 percent. Moreover, because the potential margins from UNE-based competitive entry are narrow, a 15 percent overstatement in UNE prices (*i.e.*, at least a 10 percent increase in CLEC costs) is likely to eliminate the potential for any profit from competitive entry by most CLECs in most markets.

9. Input cost overstatements of this magnitude necessarily trigger significant reactions by CLECs. Because a BOC's prices for its retail services effectively impose a cap on the price that any CLEC can charge for providing competitive local telephone service, CLECs cannot engage in the typical response of firms faced with an increase in input prices: charging higher retail prices. In consequence, the effect of even relatively modest increases in UNE prices will be effectively to bar CLECs from entering local markets or to cause them to provide service only to the highest margin segments of those markets. This competitive reality is illustrated by recent developments in local exchange markets where potential CLECs are declining entry altogether or restricting their offerings only to certain classes of customers such as business customers or only extremely high volume or low-cost residence customers,[4] and are even cutting

[3] *See* WorldCom *Ex Parte* letter to Magalie Roman Salas in CC Docket No. 01-9, dated February 14, 2001, at 13. Indeed, 70 percent is a very conservative figure. Unfortunately, it is more typical to find UNEs priced at levels that amount to 90 percent (and sometimes more) of a CLEC's potential revenues.

[4] A recent report by the Texas Public Utilities Commission reveals that most of the CLECs in Texas are ceasing or significantly cutting back their residential local market offerings. *See Report to the 77th Texas Legislature, Scope of Competition in Telecommunications Markets of Texas,* Public Utilities Commission of Texas, at 54-61 (Sprint, WorldCom and Verizon and Excel Communications are all either significantly reducing their presence in residential voice market or ceasing those services altogether).

back on their marketing of existing local exchange offerings.[5] Although all local markets in the nation will be affected by overstated UNE prices, the most severe competitive impact is likely to occur in residential and rural local exchange markets, where profit margins are lower than for business and urban residential customers.

II. AN OVERSTATEMENT OF UNE PRICES ABOVE TELRIC LEVELS SERIOUSLY IMPEDES COMPETITIVE ENTRY.

10. Inflated prices for UNEs reduce the net revenues (*i.e.*, gross revenues minus purchased input costs) received by CLECs. The question is whether the reduction in net revenues occasioned by even a modest overstatement of prices above TELRIC levels is likely to damage CLECs' profitability to the point that CLEC entry into local exchange markets is effectively precluded. It is a truism that in a perfectly competitive market, even a dollar's increase in the price of inputs above cost that is specific to a certain class of firms (*i.e.*, unintegrated CLECs), and that is not also experienced by a different class of firms (*i.e.*, integrated ILECs), would cause unintegrated CLECs not to enter a market, or if already present, eventually to exit. Nonetheless, it is useful to illustrate the impact of varying levels of input-price increases on the financial condition of CLECs and for large firms more generally.

11. Even though the financial condition of particular CLECs may not be sufficiently ascertainable that the effect of imposing an unwarranted increase in their input prices can be directly calculated until after they cease operations, such a calculation can be performed for the typical large firm in U.S. industry whose financial data are easily available.[6] I do this by

[5] *See id.* (noting that Sprint, MCI ~~Worlcom~~ WorldCom and ~~Verison~~Verizon/VSSI are all focusing on the provision of data services rather than residential or long distance services which are now far less profitable).

[6] The financial condition of a particular CLEC is often difficult for an "outsider" to determine, for a variety of reasons. For example, the CLEC may be privately owned, or may have obtained its financing through private sources. Information on other factors that affect a CLEC's financial

examining the financial data reported by the firms comprising the S&P 500 (as reported by Compustat), to evaluate how a decrease in the net revenues of these companies by specified percentages would affect their financial positions.[7] Note that because the firms selected to be included in the S&P 500 list are among the most stable and financially strong in the U.S. economy, the financial consequences to the CLECs from an equivalent increase in their input prices are likely to be far more dire.

12. Table 1 demonstrates the financial effects of declines of 0%, 5%, 10%, 15% and 20% in the net revenues of the S&P 500 firms – which would result if, assuming that input costs amount to two-thirds of these firms' gross revenues, input prices were elevated by 0%, 7.5%, 15%, 22.5% and 30%, respectively, and these firms had no flexibility to raise their retail prices in response.[8]

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condition, such as the amount of goodwill and the CLEC's contractual obligations, may not be publicly available.

[7] Compustat, a division of Standard & Poor's, collects annually a wide selection of data on the major firms in the United States economy.

[8] Microsoft Excel software collecting the Compustat data and performing these financial calculations was developed for AT&T by The Brattle Group of Cambridge, Massachusetts.

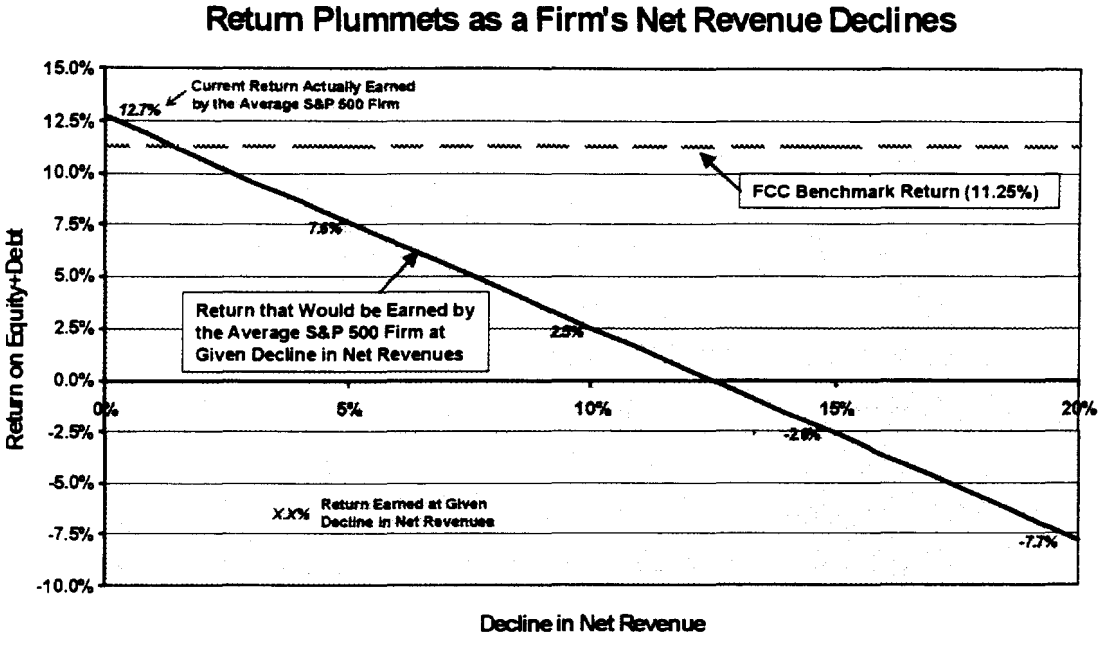
Table 1: **Returns to the Total S&P 500**

	Decline in Net Revenue of:				
Average Return Measure	***0%***	***5%***	***10%***	***15%***	***20%***
EBT Margin	13.1%	8.5%	3.4%	-2.3%	-8.7%
Return on Equity+Debt	12.7%	7.6%	2.5%	-2.6%	-7.7%
Return on Equity	17.4%	9.0%	0.5%	-7.9%	-16.3%
EBITDA Margin	22.7%	18.6%	14.1%	9.1%	3.4%
EBIT Margin	16.7%	12.3%	7.5%	2.0%	-4.1%

Source: Compustat Database, Year-end 1999

13. Table 1 shows that if a S&P 500 firm's net revenues are reduced by 5% (as would occur if input prices amounting to two-thirds of its gross revenues were elevated by 7.5%), its initial return on Equity+Debt of 12.7% would be reduced by 40% (or over 500 basis points) to a new return level of 7.6%.[9] An overstatement of input prices of just 10% (corresponding to a 6.7% reduction in net revenues if purchased inputs amount to two-thirds of the firm's gross revenues) results in a reduction in the Return on Equity+Debt by more than in half from its base value. If the input cost increase is sufficient to reduce net revenues by 10%, Return on Equity+Debt is cut by 80% (or over 1000 basis points) to a new return level of only 2.5%.

[9] The return measure most comparable to that popularly examined by regulators is Return of Equity+Debt. While not exactly equaling the Return on Ratebase ("ROR") measure that is the focus of most regulatory proceedings, this measure tends to be similar in magnitude to regulatory ROR and, most importantly, is likely to vary similarly with ROR as net revenues are reduced.



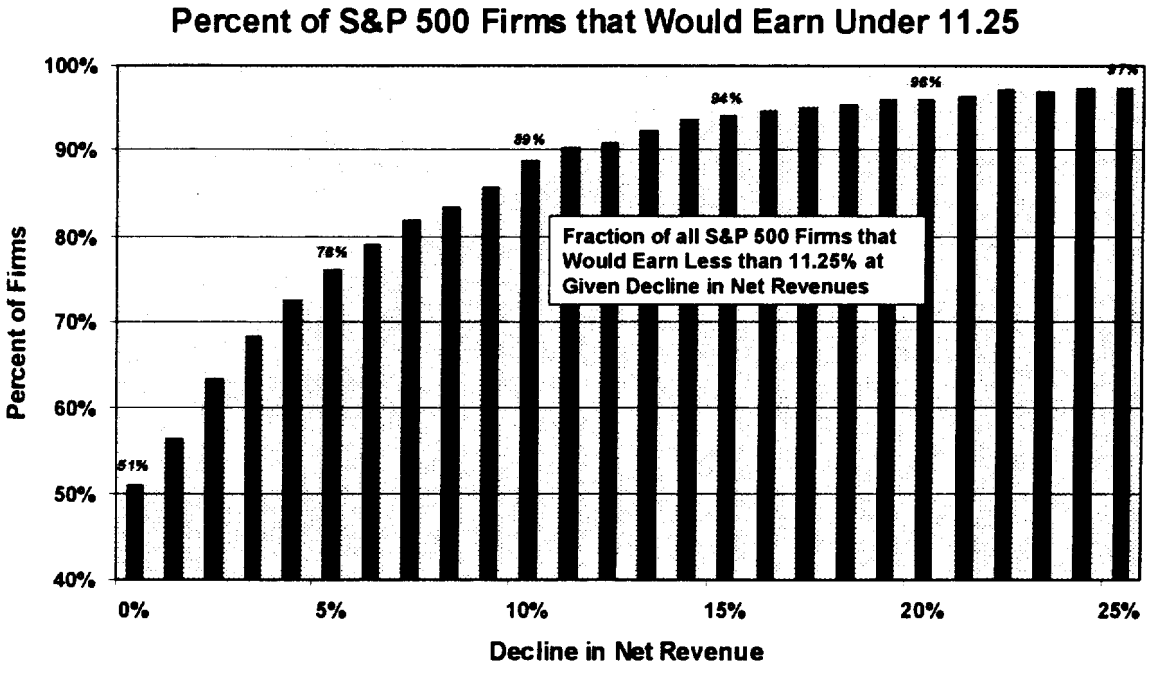
14. Furthermore, as shown in Table 2 below, a net revenue reduction of 10% (as would occur if input prices amounting to two-thirds of the firm's gross revenues were elevated by 15%) is sufficient to ensure that almost 9 out of every 10 firms in the S&P 500 would have a Return on Equity+Debt that is less than 11.25%.[10]

[10] In its Universal Service, Price Cap and ROR Prescription proceedings, the Commission found 11.25% to be the target ROR for ROR-regulated ILECs and for Universal Service provision, and a return of 10.25% to be the minimum ROR that a price cap-regulated ILEC must be earning before being awarded a rate increase. Thus, even an input price overstatement that reduces a CLEC's net revenues by only 5% would be sufficient to cause the Commission's rules to offer an upwards rate adjustment or support increase – if the affected party was a monopoly ILEC.

Table 2: **Return on Equity+Debt in the Total S&P 500**

		Decline in Net Revenue of:				
Return on Equity+Debt		***0%***	***5%***	***10%***	***15%***	***20%***
No. of Firms with Returns:	< 11.25%	227	338	395	418	427
No. of Firms with Returns:	> 11.25%	218	107	50	27	18
Total No. of Firms		445	445	445	445	445

Note: Required data are missing for 55 firms. Total sample size = 445 firms.
Source: Compustat Database, Year-end 1999



15. Given the magnitude of the deterioration in financial position that results from these moderate declines in net revenues, it is clear that a permanent overstatement of input

costs of as little as 5% or 10% would cause either the immediate bankruptcy or imminent restructuring of most firms in the S&P 500. Because most CLECs are less well capitalized than the firms that comprise the S&P 500, the financial deterioration that they would suffer from comparably elevated input prices would be even more severe – and their market exit would be even more speedy and complete.

16. As detailed in Table 1, an examination of other measures of financial status suggest the same result. One such measure is Earnings Before Interest, Taxes divided by Net Sales (EBIT margin). EBIT margin indicates the cash flow that is generated before interest and taxes are paid. Because interest and tax payments are mandatory for a going firm, EBIT margins must be sufficient to cover these expenses. When net revenues are reduced by 10%, EBIT margins decline by 920 basis points for the entire S&P 500 and by 820 basis points for the ILEC members of the S&P 500.[11] Even under the "rosiest" measure of financial performance – Earnings Before Interest, Taxes, Depreciation and Amortization divided by Net Sales (EBITDA margin) – a modest decline in net revenues spells significant financial damage.[12] For CLECs and other nascent firms that rely heavily on debt financing, declines of either magnitude would severely injure their ability to secure any debt financing, or to service existing debt.

[11] Table 1 shows that the average firm in the S&P 500 has an EBIT margin of 16.7%. However, as shown in Table 3 below, the firms in the S&P 500 that are predominantly incumbent local exchange carriers (Alltel, BellSouth, CenturyTel, Qwest, SBC and Verizon) have average EBIT margins of 26.3%, because the local exchange industry is both profitable and capital-intensive.

[12] EBITDA margin indicates the maximum cash flow that is generated before non-operating expenses are considered.

Table 3: **Returns to the ILECs in the S&P 500**

	Decline in Net Revenue of:				
Average Returns Measure	***0%***	***5%***	***10%***	***15%***	***20%***
EBT Margin	21.2%	17.1%	12.5%	7.3%	1.5%
Return on Equity+Debt	13.5%	11.1%	8.6%	6.2%	3.8%
Return on Equity	32.3%	23.1%	13.9%	4.7%	-4.5%
EBITDA Margin	44.0%	41.1%	37.8%	34.1%	30.0%
EBIT Margin	26.3%	22.4%	18.1%	13.3%	7.9%

Source: Compustat Database, Year-end 1999

17. Moreover, analyses of the effects of such declines in net revenues on the S&P 500 ILECs greatly understate the likely financial impact on the CLECs. The ILECs in the S&P 500 are among the most heavily and conservatively capitalized, and financially strong companies in the entire U.S. economy. By contrast, due to their market position as insurgents, CLECs are typically far less well capitalized, more reliant on aggressive debt financing, and less financially strong than the ILECs. Indeed, there are no "pure" CLECs that have the financial status to yet qualify to be members of the S&P 500.

18. Perhaps the best set of CLEC-surrogate firms that are members of the S&P 500 are non-ILEC telecommunications carriers. These companies include cellular carriers, cable television carriers and interexchange carriers (AT&T, Comcast, Global Crossing, Nextel, Sprint FON, Sprint PCS, and WorldCom). Because of these firms' incumbent positions in their non-CLEC cellular, cable or interexchange markets, they also are likely to be much more financially secure than pure CLECs. Yet, as Table 4 demonstrates, a given reduction in net revenues would have a far more dire effect on this class of firms than on the S&P 500 or the ILECs generally.

Table 4: **Returns to Cable, Cellular and Interexchange Carriers in the S&P 500**

	Decline in Net Revenue of:				
Average Return Measure	***0%***	***5%***	***10%***	***15%***	***20%***
EBT Margin	-18.5%	-24.7%	-31.6%	-39.4%	-48.1%
Return of Equity+Debt	2.7%	1.5%	0.2%	-1.0%	-2.2%
Return on Equity	-9.7%	-12.2%	-14.7%	-17.2%	-19.7%
EBITDA Margin	13.0%	8.5%	3.4%	-2.3%	-8.7%
EBIT Margin	-6.8%	-12.4%	-18.6%	-25.6%	-33.5%

Source: Compustat Database, Year-end 1999

19. Note the far greater leverage of this group vis à vis the more conservative financing of the S&P 500 as a whole, and the ILECs in particular. The difference between Earnings Before Taxes divided by Net Sales (EBT margin) and EBIT margin is Interest divided by Net Sales. Comparing Table 4 with Tables 2 and 3, shows that for the non-ILEC telecommunications carriers as a group, interest expense is, roughly, 12% of Net Sales. But when this same difference is calculated for the S&P 500 as a whole, interest expense is shown to be only about 4% of net sales; or when calculated for the ILECs only, about 5% of net sales. This greater leverage shows that these CLEC-surrogates are much weaker financially – and thus would be affected even more adversely by an overstatement of input prices – than the average firm in the S&P 500 Index.

III. AN OVERSTATEMENT OF UNE PRICES ABOVE TELRIC LEVELS WOULD LIKELY CUT-OFF RESIDENTIAL AND RURAL MARKETS FROM COMPETITION.

20. If all customer segments provided equal profit margins to a CLEC, an increase in input prices would be "dichotomous," that is, would have one of two effects: either the input price increase would be sufficient to prevent CLECs from providing local exchange